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JAPAN, SII AND THE INTERNATIONAL HARMONIZATION OF DOMESTIC ECONOMIC PRACTICES

*Gary R. Saxonhouse**

INTRODUCTION

The Structural Impediments Initiative ("SII") discussions, the first stage of which concluded with a report on June 28 of last year, have been heralded as a new departure in international economic relations. Instead of talking about the removal of barriers at national borders, the United States and Japan have been discussing the relationship between international trade, international payments balances and domestic economic institutions. Trade negotiators have been exploring whether the harmonization of domestic economic institutions can allow for more intimate as well as more balanced economic relations between the United States and Japan. Concern with the international harmonization of institutions often seems at odds with the theory of comparative advantage. This article suggests, however, that there are new developments in the theory of international trade which indicate that the harmonization of domestic institutions among trading partners may well enhance the welfare of all concerned. In practice, however, a number of the proposals being urged on the Japanese in the specific context of SII may have consequences quite the opposite of what is expected by their proponents.

I. TRADE PERFORMANCE, TRADE THEORY AND TRADE POLICY

If the record of global trade over the past one hundred years is examined, excluding the ten years of war and dislocation between the mid-1930s and the mid-1940s, there remain two rather distinct forty-five-year periods.

In the first period, which extended from the late nineteenth century to the mid-1930s, global trade lagged well behind growth in world economic production. International trade was an increasingly less important part of economic activity. This lag was true not only globally, but also for each of the major industrialized economies, with the single exception of Japan.¹

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1. See A. MADDISON, *PHASES OF CAPITALIST DEVELOPMENT* apps. A, F (1982).

There is nothing unusual in this performance. Surprising as it may now seem, for much of both the nineteenth and the twentieth centuries, it was commonplace for economists to believe that as nations grew, trade would grow less important. In 1821 Robert Torrens wrote, "As the several nations of the world advance in wealth and population, the commercial intercourse between them must gradually become less important and beneficial."²

Torrens' views were elaborated on by succeeding generations of economists. At the turn of the century, Werner Sombart formulated the so-called "law of the declining importance of export trade."³ Later economists such as Dennis Robertson and John Maynard Keynes suggested that increasing wealth extinguishes the need for trade.⁴

At the core of these analyses is the theory of comparative advantage. Increasing wealth is understood as making advanced countries more alike. The theory of comparative advantage predicts that the more countries are alike the less they will trade. In its way this theory provides the intellectual rationale for why international trade regimes such as the General Agreement on Tariffs and Trade ("GATT") traditionally have viewed domestic economic institutions as beyond their purview. Provided national treatment is accorded foreign participants, countries can organize their domestic economies however they wish. Barriers at the border reduce trade volume, and the goal of the international regime is to remove these barriers. By contrast, domestic institutions, however different they may be, are generally left alone because their consequences are arguably pro-trade.

What has just been sketched out is an old view. Facts have changed, theories have changed and even the international regime is changing. In the forty-five years since 1945, global trade has run well ahead of global Gross National Product ("GNP"), in marked contrast to preceding years. Again, this is true not only in aggregate, but also for all the major industrialized economies. And Japan's behavior remains a bit different. Among the major industrialized economies in the post-war period, Japan has experienced by far the smallest rise in its trade-to-GNP ratio.⁵

What has caused this divergent behavior? The past forty-five years

2. R. TORRENS, *ESSAY ON THE PRODUCTION OF WEALTH* 288 (1821), *quoted in* R. LIPSEY, *PRICE AND QUANTITY TRENDS IN THE FOREIGN TRADE OF THE UNITED STATES* 37 n.1 (1963).

3. W. SOMBART, *DIE DEUTSCHE VOLKSWIRTSCHAFT IM NEUNZEHNTEN JAHRHUNDERT* 368-70, 388 (1923).

4. See Keynes, *National Self-Sufficiency*, *YALE REV.* 755, 760 (Summer 1933).

5. See A. MADDISON, *supra* note 1, at apps. A, F.

have witnessed unprecedented improvement in the prosperity of the most advanced industrialized economies. On the basis of past experience and traditional theory, trade should have grown slowly, particularly among these economies. Yet just the opposite has occurred. The most obvious reason for this change in performance is well known: the past forty-five years have seen a sharp reversal in the protectionist trends which dominated international commercial policy in the early decades of the twentieth century. As important as the change in international commercial policy has been, however, it is insufficient to explain the explosion of post-war trade.

In the last decade or so, economists have increasingly appreciated that a large share of international trade is driven by considerations other than simple differences in local conditions. If allowance is made for the reality that any given industry will produce not one but a wide variety of goods and that these varieties are likely to be produced by technologies characterized by scale economies, countries will specialize not so much by industry as by variety of good. In consequence, newer trade theories predict that differences between countries may actually undercut rather than promote trade. By contrast, the more countries resemble each other, the more varieties of mutually desired products will be produced and the more beneficial trade will be. This new theory fits the experience of the past forty-five years. The great increase in the prosperity of the post-war period has led to a sharp decline in the variance of per capita GNP among the advanced industrialized economies, and with this new convergence of living standards has come an explosion in international trade.⁶

In the years before 1945, international trade meant exporting goods from one group of industries and importing the goods of a different group. In the past forty-five years, however, international trade has more often meant both importing and exporting goods from the very same industry. Today countries specialize to take advantage of economies of scale and exchange different varieties of the same product. Economists generally call the old kind of trade inter-industry trade while the new trade is described as intra-industry trade.⁷ The new trade theory incorporating economies of scale and differentiated products is an effort to explain intra-industry trade.

The two different kinds of trade can have very different consequences for international economic relations. Inter-industry trade

6. See Helpman, *Imperfect Competition and International Trade: Evidence from Fourteen Industrial Countries*, 1 J. JAPAN. & INT'L ECON. 62, 74 (1987).

7. E. HELPMAN & P. KRUGMAN, MARKET STRUCTURE AND FOREIGN TRADE 131-32 (1985).

based on differences between countries can have politically contentious consequences for national income distribution. A country with scarce and expensive labor resources will import labor-intensive goods from countries with cheap labor. This makes the country as a whole better off but it leaves labor and its representatives protesting liberal trade policies. By contrast, trade which is undertaken by countries which are quite similar to each other, and which primarily involves exchanging different varieties of similar goods produced using similar technologies, is unlikely to have the income redistribution consequences and political ramifications of inter-industry trade.

There have always been important political constituencies in the major industrialized nations supporting trade in otherwise unavailable natural resource products. The great post-war success in removing barriers to international trade among the advanced industrialized nations has been built upon joining this traditional support to new constituencies supporting the highly beneficial and non-disruptive trade based on intra-industry specialization.

Japan is neither a natural-resource-based exporter nor, until possibly very recently, a major participant in intra-industry trade. Japan's continued focus on inter-industry specialization has meant that at best, even if the expansion of Japanese trade results in a net improvement in foreign welfare, it will do so at the expense of altering the politically sensitive international distribution of income. At worst, an expansion of Japanese trade could reduce foreign welfare by undermining economic rents embodied in the profits and high wages of rival foreign industries. While there is good reason to believe that, on balance, growth in Japanese trade has been beneficial, unlike the trade of other advanced industrialized economies, it has not created powerful liberal trade constituencies within its trading partners. Rather, the faster-than-desired structural adjustment imposed on Japan's trading partners has nurtured protectionist interests. As long as the Japanese economy was relatively small, complaints were localized, confined to particular sectors and often easily overwhelmed by the broader constituencies favoring more liberal trade. As Japan has become a much larger force in the global economy, attention has come to focus on the disruptive features of international trade at the expense of its many benefits.

Mutually beneficial inter-industry trade is based on the existence of differences among countries, while mutually beneficial *intra*-industry trade is based on similarities among countries. From the Japanese perspective, it is no doubt puzzling that foreign diplomats continually request that Japan become ever more like its trading partners. From the

perspective of traditional trade theories, removing what is distinctive about Japan would appear to remove the basis for trade. Other nations, however, are approaching Japan from a different perspective. By asking Japan to harmonize a wide array of its domestic economic practices with foreign practices, they are hoping to create a basis for greatly expanded, mutually beneficial intra-industry trade between Japan and its trading partners. This is viewed as the best hope for re-invigorating the constituency in favor of a liberal trading system.

Whatever the rationale of foreign diplomats, it is by no means clear what the harmonization of Japanese economic policies with foreign practices will bring insofar as the structure and volume of Japan's foreign trade are concerned. Japan's failure to participate in a significant way in intra-industry trade and Japan's distinctive trade performance in both the pre-war and post-war periods may be due less to distinctive Japanese government policies than to Japan's geography and distinctive national endowments. By importing massive amounts of foreign technology in both the pre-war and post-war periods, Japan achieved rapid technological improvements which allowed more efficient use of labor resources. Before 1945, unlike all the other major industrialized economies, labor was relatively abundant in Japan. Rapid, labor-saving technological change made Japan's abundant resource more plentiful, making Japan even more different from its trading partners and accelerating the growth of Japanese trade.⁸

In the post-war period, labor has become as scarce in Japan as in all the other major industrialized economies. Because it has helped Japan preserve its scarce resources and reduced Japan's differences from its trading partners, rapid, labor-saving technological change no longer has an unambiguously positive impact on the volume of Japanese trade. And technological change has done little in the post-war period to accelerate that part of trade premised on differences. Japan is still too different and geographically distant from other major industrialized economies to be a major participant in the fast-growing segment of global trade based on intra-industry specialization.⁹

II. THE STRUCTURAL IMPEDIMENTS INITIATIVE

There is surely little firm legal basis for making the international harmonization of domestic economic practices the centerpiece of eco-

8. For an analysis of why trade will increase under these conditions, see Hodjera, *Unbiased Productivity Growth and Increasing Costs*, 15 OXFORD ECON. PAPERS 244 (1963).

9. See Saxonhouse, *Differentiated Products, Economies of Scale, and Access to the Japanese Market*, in *TRADE POLICIES FOR INTERNATIONAL COMPETITIVENESS* 145 (R. Feenstra ed. 1989).

conomic diplomacy with Japan. Article III of the GATT, which discusses the so-called national treatment obligation, specifically rejects the harmonization of domestic practices. It simply requires that imported goods be accorded the same treatment as goods of local origin with respect to matters under government control, such as regulation, taxation and government procurement. Article III notwithstanding, since May 30, 1989, when the United States announced its intention to commence the SII discussions, the harmonization of many U.S. and Japanese domestic economic institutions has become a major element of U.S. economic policy towards Japan.¹⁰

For all the publicity surrounding SII, these talks are not nearly so unique as is generally imagined. During the four years immediately preceding the SII talks, the United States and Japan had been discussing the harmonization of domestic economic institutions in an exercise known as the Structural Adjustment Dialogue.¹¹ Indeed, it was generally imagined, particularly on the Japanese side, that SII, which was tacked on as something of a sop to Congressional critics of Japan when the Bush Administration made its Super 301 determination in the spring of 1989, would have much the same form and substance as this relatively low profile exercise. This forecast has proven to be quite mistaken.

On an informal basis, at least some of the issues being taken up at SII have been raised again and again with the Japanese government for almost two decades. A major part of the SII discussion has been concerned with undoing the consequences of Japan's Large-Scale Retail Store Law. In 1972, two years before this law was even passed, U.S. embassy officials and leaders of the American Chamber of Commerce in Japan were making speeches denouncing many features of the Japanese distribution system and the relatively lax Department Store Law which governed retail expansion before the mid-1970s. The substance of SII has been on the minds of America's diplomats and businessmen for a long, long time.¹²

However persistent complaints may be about distinctive Japanese economic practices, the impetus behind the international harmoniza-

10. The final report on the first phase of the SII discussions, known as the JOINT REPORT OF THE U.S.-JAPAN WORKING GROUP ON THE STRUCTURAL IMPEDIMENTS INITIATIVE [hereinafter THE SII REPORT], was issued June 28, 1990.

11. See W.A. Wallis, Structural Adjustment, Dialogue, and U.S.-Japan Economic Relations, Address Before the Annual Executive Committee Meeting of the U.S.-Japan Business Council 4 (Feb. 16, 1987) (U.S. Dept. of State, Current Policy No. 924).

12. See, e.g., W. Dizer, Some Observations on the U.S.-Japan Trade Relationship by Japan-based American Businessmen, presented at Joint Meeting of Advisory Council on Japan-U.S. Economic Relations and Japan-U.S. Economic Council (June 15-17, 1972).

tion of domestic economic practices in recent years has had a much broader agenda than simply removing the allegedly illegitimate basis of Japanese economic success. It also concerns a larger global trend. "EC 92" is also about the international harmonization of domestic economic institutions, and not only among those in the European Community. The European Community is demanding that its major trading partners harmonize their domestic institutions with those of the Member States. This trend towards international harmonization is so strong that it is almost possible to amend the famous claim by Lester Thurow that "the GATT is dead" with the query, "Is national treatment dead?"

All too many commentaries on SII have noted that these discussions have also been unusual in that Japan is being pressured by its major trading partners to make its economy more efficient by removing all manner of barriers against domestic competition.¹³ Success for the United States in SII means a more competitive Japanese economy. While this may indeed be the result of SII, there is nothing at all unusual about this outcome. This is a lesson in economics too little understood. The primary beneficiary of the removal of trade barriers is almost always the country doing the removing, not the foreign trading partner seeking market access. It is the nature of economic processes and not Japanese diplomatic guile that usually makes the Japanese economy better off after concluding a bitter trade negotiation with the United States. If Japan in the SII negotiations were really in a position to force American leaders to ignore powerful domestic lobbies and to remove barriers to American goods, commentators around the world would be regularly congratulating Washington's negotiators on skillfully turning Japanese pressure to American economic advantage.

The SII negotiations have been costly in the sense that they have engaged the energies of American and Japanese government officials at the very highest levels over a considerable period of time. Have these discussions been worth this great effort? Are the right issues being negotiated? Should the talks continue? What will be the impact of the present set of negotiations?

Six features of the Japanese economy have been addressed in the SII discussions.¹⁴ These include: 1) saving and investment imbalances; 2) price differentials between Japan and elsewhere; 3) land use; 4) the

13. Frankel, *SII*, *EKONOMISUTO*, June 5, 1990, at 10-13.

14. Seven features of the U.S. economy have also been included in SII. These are: 1) U.S. saving and investment patterns; 2) corporate investment activities and supply capacity; 3) corporate behavior; 4) government regulations; 5) research and development; 6) export promotion; and 7) workforce education and training. While equal time has been allowed for U.S. and Japanese topics during the SII negotiations, it is difficult to characterize these discussions as symmetrical.

distribution system; 5) *keiretsu* (industrial groups) and 6) exclusionary business practices. The first two topics have been introduced by American negotiators in the interest of defining problems that might be corrected by structural changes within the rubric of the last four topics.

A. *Savings-Investment Imbalances*

The Bush-Uno joint statement issued in July, 1989, at the Bonn Summit authorizing the SII talks emphasized the importance of correcting imbalances in national savings and investment patterns which create current account imbalances. At just about the same time that American and Japanese officials were organizing the talks, however, the World Bank issued an urgent call for more, not less, global savings. With this in mind, it was decided that SII should not ask the Japanese to save less, except in those instances where Japanese savings appeared to be propped up by government policies which bias the choice between savings and consumption. While the U.S. government has not asked Japan to save less, it has urged Japan to spend more by increasing its public investment. From the World Bank perspective, however, the impact on international capital flows of Japan saving less or spending more is identical.

The original outlook of American officials in raising the public investment issue was long-term. During the 1980s, a succession of Japanese prime ministers worked to cut what had once been a very large Japanese government deficit by restraining public spending.¹⁵ With private savings continuing at a high level, the decline in Japan's government deficit allowed it to generate a large current account surplus. Fearful that this large surplus may persist, American officials have hoped to reverse Japanese government policies of the 1980s by emphasizing that the 1990s should be a time to vastly improve many of Japan's long-neglected public amenities. American officials have regularly pointed out to their Japanese counterparts that government objectives from the mid-1970s for housing, sewerage, parks and waste disposal are still nowhere close to being met.¹⁶

For their part, Japanese officials have complained that American participants in SII are showing insufficient appreciation of the considerations which drove Japan's fiscal reconstruction in the 1980s. Among the advanced industrialized countries, Japan has had one of

15. See the early criticism of this policy in Bergsten, *What to Do About the U.S.-Japan Economic Conflict*, 60 FOREIGN AFF. 1059 (1982).

16. M. Boskin, Keynote Address to the Symposium on Structural Adjustment of the Asia-Pacific Economies and the Role of the OECD 10 (Oct. 3, 1989).

the youngest populations, and with it correspondingly low expenditures on social security. However, more than in any of the other advanced industrialized countries, the average age of Japan's population is increasing rapidly. Before very long, Japan's population will be among the oldest in the advanced industrialized countries. In the absence of expenditure declines resulting from slower population growth, the heavy social security expenditures associated with an aging population, under current benefit levels, will force very significant deficits on Japan's public sector.¹⁷ It is argued that much of the Japanese government's continuing interest in fiscal austerity has been geared to these long-term considerations and the need to delay as long as possible the politically unwelcome downward revision in the benefit levels available to future social security recipients.

While none of this is meant to suggest that there is not a manifest need for significantly larger Japanese expenditures for social infrastructure, in the view of many Japanese officials current Japanese public sector surpluses have already been committed for other purposes.¹⁸ Japan has too long suppressed the aspirations of its citizens for better public infrastructure and social overhead capital, but it is important to remember that the average quality of life has improved by a far greater extent in Japan than in any other major industrialized country over the course of the past 40 years.

The SII talks began as something of a departure in U.S.-Japanese economic relations because of their emphasis on deep-rooted issues of Japan's economic structure. They ended, however, where negotiations between the United States and Japan have ended so often in the last twenty years. Great pressure has been brought to bear on Japan to increase its public spending, not for long-term considerations, but rather in the interest of short-term, international macroeconomic coordination. In the spring of 1990, the Bush Administration became pre-occupied with forecasts that the American current account deficit would reverse course and begin increasing once again.¹⁹ This concern led it to make obtaining a firm commitment from the Japanese government to expand domestic demand by increasing public spending one of the very highest priorities of the SII discussions.

Partially in response to requests at the SII talks, the Japanese government has agreed to undertake 430 trillion yen in new public invest-

17. However, Professor Yukio Noguchi has argued that the aging of the Japanese population will leave Japan's fiscal balance unchanged. Y. Noguchi, *Japan's Fiscal Policy and External Balance* 8-14 (Sept. 1989) (draft).

18. H. ISHI, *THE JAPANESE TAX SYSTEM* 284-86 (1989).

19. NOMURA RESEARCH INSTITUTE, *NOMURA INVESTMENT REVIEW* 3 (Feb. 1990).

ment during the 1990s. This is a substantial increase over the 263 trillion yen spent on public investment during the 1980s. This spending plan includes record high public investment during the coming fiscal year.²⁰ In view of the slowdown in the global economy, in part as a result of the Gulf crisis, this improvement in Japan's fiscal stance is viewed by many as highly beneficial.

B. Price Differences

It has long been appreciated that cross-national price differences are a good way to measure the impact of non-tariff barriers. Unhappily, the absence of strictly comparable cross-national price data has made it difficult to use this approach in the always contentious discussions about the impact of Japanese trade barriers on Japanese trade volumes and structure.²¹

For example, during the past year, much has been made of the so-called "Forty-Seventh Street Photo phenomenon" which claims that many Japanese products — in particular, cameras — are sold abroad at lower prices than at home.²² Many Japanese government officials have vehemently rejected this claim, arguing that the products being priced cross-nationally are simply not comparable. For example, they argue that Forty-Seventh Street Photo in New York City charges low prices only because it is selling older models of cameras no longer desired by the Japanese consumer. This controversy bubbled over in the SII discussions in the fall of 1989. As an outcome of heated discussion among SII participants, the U.S. Department of Commerce and Japan's Ministry of International Trade and Industry ("MITI") agreed to conduct a detailed joint price survey which would take special pains to price comparable products in the United States and Japan.

The survey that has been conducted appears to be scrupulous in its efforts to obtain comparable retail price data. Considerable effort has been expended to insure that comparable products are being priced in comparable retail locations. Price observations have been separated according to whether they are gathered in specialty shops, discount houses or department stores. Unfortunately, the products included in this survey in no sense constitute a random sample of the universe of comparable products available in U.S. and Japanese markets. Rather,

20. THE SII REPORT, *supra* note 10, at I-2 (report by Japanese Delegation).

21. G. SAXONHOUSE, WHAT'S WRONG WITH JAPANESE TRADE STRUCTURE 10 (Pacific Economic Paper No. 137, 1986); A. DEARDORFF & R. STERN, METHODS OF MEASUREMENT OF NON-TARIFF BARRIERS 27-28 (University of Michigan Institute of Public Policy Studies Discussion Paper No. 203, 1984).

22. Fallows, *Containing Japan*, ATLANTIC MONTHLY, May 1989, at 43.

they are the product of weeks of acrimonious negotiations between Commerce and MITI. Indeed, the final list could not be agreed upon until the day before the survey started.

The actual survey results contain some surprises. While there are certainly many instances of Japanese-produced goods having lower prices in the United States than in Japan, the "Forty-Seventh Street Photo phenomenon" does not seem to be pervasive even at Forty-Seventh Street Photo. Of fourteen Japanese-produced cameras and video camera related products, only six are cheaper in the United States. Overall, twenty-six of fifty-seven Japanese products were found to be cheaper in the United States than in Japan. By striking contrast, only four of thirty-five U.S. products and only two of twenty-one European products are cheaper in Japan than in the United States.²³

Simply counting up observations of what, in any event, is not a randomly drawn sample may yield a very misleading impression. The determinants of the U.S. and Japanese price differences found in the SII sample have been analyzed in more systematic statistical fashion.²⁴ This analysis rejects the "Forty-Seventh Street Photo phenomenon" and finds that there is no statistically significant difference between U.S. and Japanese retail prices for goods produced in Japan. By contrast, the hypothesis that there is no statistically significant difference between U.S. and Japanese retail prices for goods produced in the United States and Europe cannot be accepted.

Such results may present a problem for those who would argue that the Japanese market for manufactured products is highly protected. If that were so, both Japanese and foreign products should have much higher prices in Japan than abroad. The fact that only foreign products have high prices in Japan suggests a different interpretation. The high prices for U.S. and European products in Japan may reflect the marketing strategies of oligopolistic firms. U.S. and European firms may have concluded that they can maximize profits in the Japanese market through a low-volume, high-price strategy.

C. Land Use

There is every reason to believe that deregulation of land and some decline in Japanese land prices might benefit the Japanese economy. Last year the value of all land in Japan amounted to about \$10 trillion, four times the total land value of the United States. Yet, as has been

23. U.S. Dep't of Com. and Japan Ministry of Int'l Trade and Indus., *Joint Survey on United States and Japan Retail Prices* (Washington, D.C., Nov. 1989).

24. W. Cline, Japan's Trade Policies 22-26 (paper delivered to Ministry of International Trade and Industry Research Institute) (May 1990) (draft).

noted, an explorer from outer space would almost certainly choose to claim the 3.6 million square mile territory of the United States rather than Japan's 146,000 square miles.²⁵

U.S. negotiators have reasoned that better use of and lower prices for land might reduce saving and release some spending for purchase of imports. The issue, however, is more complicated. The relationship between the high price of land, housing conditions and Japan's high rate of personal savings is not straightforward.

Housing-related saving is not a major cause of Japan's high savings rate. As might be expected, savings motivated by the desire to own residential real estate assets, in aggregate, is largely matched by dis-saving for much the same purpose. High land prices increase the wealth of existing owners. It is not obvious that their increased consumption out of capital gains falls short of the increased savings of young families seeking housing.

A decline in the price of land should stimulate a short-term boom in housing investment. Given the very large role that land plays in the Japanese household balance sheet, in the long run this new housing investment will be overwhelmed by increases in the household savings rate needed to compensate for losses in household wealth related to declining land prices.²⁶ The net impact may well be to increase the household sector's financial surplus. In consequence, if SII is supposed to work to reduce Japan's current account surplus, policies which encourage a decline in Japanese land prices may be counter-productive.

Quite apart from the possible counterproductive impact on Japan's current account surplus, lower land prices may also have other consequences for Japanese resource allocation which might be seen as perverse from the point of view of at least some American interests. Current Japanese land use policy keeps land cheap for Japanese farmers and expensive for everyone else. To the extent that SII seeks to help American manufacturers compete with their Japanese counterparts, encouraging a change in Japanese land use policies might not be helpful.

Beyond handicapping Japanese manufacturers, current Japanese land use policies may help foreign market access into Japan through their direct impact on household behavior. Because non-traded services are by their very nature land-intensive, high Japanese land prices

25. *Id.*

26. Sachs & Boone, *Japanese Structural Adjustment and the Balance of Payments*, 2 J. JAPAN. & INT'L ECON., 286, 316 (1988).

bias household choice in the direction of traded goods. This works to increase Japanese imports of goods and to encourage Japanese travel overseas to consume foreign non-traded services.

Since at least the late 1970s it has been attractive to American officials seeking to ameliorate international economic tension to make common cause with the widespread Japanese desire for better housing conditions and to advocate changes in land use. Changes in Japanese land use policies are very much in Japan's interest and will enhance the quality of life there. While this may be sufficient reason for U.S. officials to encourage the Japanese to make these changes, it must be recognized that any connection between these policy changes and the American interest that SII has been designed to further may be quite tenuous.

However indirect may be the relationships between the change in Japanese land prices, the adjustment of the Japanese current account and foreign access to the Japanese market, policies that seek to lower the price of land appear to be popular in Japan. In response both to domestic pressure and to the SII discussions, the Japanese government is undertaking a comprehensive review and adjustment of Japan's complex system of land taxation in the interest of making taxes more equitable, neutral and simple.²⁷ The goal of this adjustment is to reduce the tax system's strong discrimination in favor of land, and among the land uses, the strong bias of the tax system against the non-agricultural use of land.

Much of the run-up in land prices in Japan in the 1980s may be less the result of structural factors and more the consequence of a speculative bubble. Since mid-1989, the Bank of Japan has successfully broken the back of Japanese land speculation by sharply increasing the discount rate. It is unlikely that any of the contemplated changes in the tax code will have as much influence on land prices as has this change in central bank policy.

D. *Financial Keiretsu*

There is widespread belief in the United States and elsewhere that Japan's bank-centered industrial groups, known as *keiretsu*, convey special competitive advantages. Because it is believed that *keiretsu* are institutions uniquely suited to the protection of domestic markets while taking aggressive advantage of foreign markets where such arrangements are prevented by law,²⁸ American trade officials have

27. THE SII REPORT, *supra* note 10, at II-3 (report by Japanese Delegation).

28. Johnson, *Their Behavior, Our Policy*, THE NAT'L INTEREST, Fall 1989, at 17, 23-24.

raised the widespread presence of this institution in Japan as an issue in the SII talks.

Japan has many *keiretsu* of one type or another, but today the six best known are Mitsui, Mitsubishi, Sumitomo, Fuyo, Dai-Ichi Kangyo and Sanwa. Mitsui, Mitsubishi and Sumitomo are directly descended from the pre-war *zaibatsu* which the Supreme Command of the Allied Powers tried to break up during the American occupation of Japan. By contrast, the Fuyo, Dai-Ichi Kangyo and Sanwa *keiretsu* have been formed largely in the years after 1945. Members of all six *keiretsu* are much less closely affiliated than is generally realized. The member firms in *keiretsu* with strong pre-war roots purchase only 14.8% of their procurement from fellow *keiretsu* members. For the more recently organized *keiretsu*, procurement from fellow *keiretsu* members is still less important, as only 8.9% of procurement is purchased from affiliated firms.²⁹

While reciprocal purchasing seems to be too weak to tie *keiretsu* together, American government officials remain highly concerned that cross-shareholding among member firms does allow the *keiretsu* as a whole effective control over any individual member firms. In fact, cross-shareholding is not nearly as pervasive nor so exclusive among *keiretsu* members as is commonly believed. Among the six best-known *keiretsu*, the average individual firm equity held by all other members of its *keiretsu* is 17.9%.³⁰ While this is a relatively small amount of cross-holding, if ownership of the firm's remaining equity is widely dispersed, even this amount might be sufficient to give the *keiretsu* control of a member firm. In fact, for a typical member firm, control of the remaining equity is not widely dispersed. Large blocks of equity are often held by members of rival *keiretsu*.³¹ Such holdings, if exercised in concert, can be sufficient to block effective *keiretsu* control of member firms.

Keiretsu ties have substance where member firms are dependent on the *keiretsu* main bank for their finance. Dependence on these main banks has declined dramatically over the past fifteen years. Between 1972 and 1983, over one-quarter of the companies listed on the first

29. KŌSEI TORIHIKI IINKAI, KIGYŌ SHUDAN NO JITTAI NI TSUITE 39-42 (1983). By including transactions between *keiretsu* firms and their important subsidiaries, these numbers may even overstate the significance of *keiretsu*. On the other hand, by including *keiretsu* trading company transactions in the denominator of procurement calculations while excluding some of these transactions from the numerator, these figures may downwardly bias the importance of *keiretsu* ties.

30. TOYO KEIZAI, KIGYŌ KEIRETSU SŌRAN (1989).

31. See generally, TOYO KEIZAI, *supra* note 30.

section of the Tokyo Stock Exchange changed their main bank.³² The weakening of *keiretsu* ties goes hand in hand with the declining dependence of large Japanese firms on their banks. In 1974, Japanese firms capitalized at more than one billion yen relied on banks for 46.7% of their new financing. Just ten years later no more than 6% of new investment by these large Japanese firms was financed by bank borrowing.³³

American government officials have been mistaken in identifying Japanese cross-shareholding as primarily a *keiretsu* phenomenon. Extensive cross-shareholding in Japan is a relatively recent occurrence. While always present to some degree since the joint-stock form emerged in Japan 115 years ago, its greatly increased importance in recent years has gone hand in hand with the increasing risk in Japan of corporate takeovers. As long as Japanese companies relied on short-term bank loans for a major part of their financing, main banks were in a position to negate the value of any takeover bid. As Japanese companies have relied more heavily on retained earnings for new financing and as financial liberalization has made the issue of new equity more practical, the veto power once exercised by a company's main bank has greatly diminished. Cross-shareholding has thus emerged as a widely recommended strategy urged by Japanese lawyers to stave off takeover bids. Rather than being part of the old *keiretsu* system, in many respects it is an alternative to it.

It is not that Japanese companies are uniquely averse to hostile takeovers of foreign origin; they are opposed to *any* hostile takeover bid, whatever the origin. While this attitude certainly constrains foreign participation in the Japanese economy, this extreme aversion can be rationalized on economic grounds. Given Japan's anemic and often nonexistent market for experienced managers, research and development personnel and even production workers, and given that all these personnel have made large firm-specific investments in human capital which can only be recouped if they remain with their firms, the typical Japanese interest in preventing a hostile takeover bid of a company must be far greater than would be the case in the United States. In the absence of a radical change in the structure of Japanese labor markets, which no one on the American side has suggested, there are very good economic reasons for the management of Japanese companies going to

32. Horiuchi, Packer, & Fukuda, *What Role has the "Main Bank" Played in Japan?*, 2 J. JAPAN & INT'L ECON. 159, 165 (1988).

33. D. Meerschman, *The Japanese Financial System* 35 (paper presented at National Bureau of Economic Research Conference on the United States and Japan: Trade and Investment, Oct. 1989).

great lengths to prevent hostile takeovers. This would be true even if Japanese companies operated under American securities law. Moreover, for all the discussion of Japanese cross-shareholding in SII, cross-shareholding is generally not against U.S. laws.

E. *Exclusionary Business Practices*

Under the general heading of Japanese exclusionary business practices, American negotiators have grouped four somewhat related topics. These include bid-rigging and the enforcement of Japan's Anti-Monopoly Law, abuse of intellectual property rights and the exclusionary procurement practices of private firms.

Bid-rigging is a problem in Japan's construction industry, but it is not a practice which is unique to that country. While there are clearly a number of specific, well-documented cases where blatant bid-rigging has occurred in Japan's construction industry, the case that this is a more serious problem in Japan than elsewhere remains to be made. While bid-rigging may be as pervasive as alleged, it is hard to see that it is having an internationally distinctive impact on the performance of the Japanese construction industry. Japan's construction industry currently employs 5.3 million workers or 9% of Japan's labor force. This is a much larger proportion of the total labor force than the 6.5% employed in the American construction industry, but it is hardly unprecedented. For example, 9% of the Italian labor force is also employed in construction.³⁴

The collusion which makes bid-rigging possible is in violation of Japan's Anti-Monopoly Act. American officials complain that the Japanese government often seems unwilling to enforce this statute, not just against bid-rigging but any collusive action. Japan's Fair Trade Commission, which is charged with enforcing this statute, prefers informal consultations with the parties concerned to any kind of formal proceeding. Since Japan's Anti-Monopoly Act contains no private right of action, this means, in comparison with U.S. or even European practice, there is very little litigation under this statute. When litigation does occur, the resulting penalties for violation of the Anti-Monopoly Law appear to be very modest.

It is ironic that at just the time when American officials are urging the Japanese government to remake their anti-trust law according to the American model, students of American productivity are arguing that it is America's anti-trust law that is undermining American performance. As William Baumol notes:

34. NIHON GINKŌ, KOKUSAI HIKAKU TŌKEI 139 (1989).

[T]he United States may well not be suffering from a loss of entrepreneurial talent and initiative, as has sometimes been suggested. Rather, if there is a problem in this arena (a conjecture that is, in any event, very difficult to test), much of the difficulty may be a misdirection of entrepreneurial talent rather than its disappearance. Moreover, whether conditions on the entrepreneurial front have or have not deteriorated, surely an injection of productive entrepreneurship should contribute to productivity. And this can be achieved by closing off, to the extent that is practicable, the most attractive opportunities for rent seeking. The Japanese example shows how this can be done by suitable alterations in the economic "rules of the game." Even if we do not want to go as far as Japan has in discouraging private antitrust suits, for example, more moderate rules of a similar sort are easily formulated. And one can be quite sure that, once suitable measures have closed off or at least impeded access to the avenues for unproductive entrepreneurship, entrepreneurial energy and talent will automatically be redirected to the productive means that still remain open. Such measures can benefit other industrialized countries, and not just the United States. However, as we have seen, there is reason to suspect that in this area it is the United States that has the most to gain.³⁵

During the time the SII talks have been ongoing, there has been a great deal of discussion both at these talks and in other fora about the procurement practices of private firms. The long-term relationships Japanese firms maintain with their suppliers are said to be a major barrier against foreign access to the Japanese market. Whatever the merits of these allegations, in the absence of market-sharing agreements which the Bush Administration opposes in principle, there may be little that can be done to force private firms to buy imports that they do not desire. If SII and other bilateral and multilateral initiatives work to insure that there is competition in Japan's final goods markets, it may make little difference to foreign welfare that Japanese firms wish to continue to purchase imports from high-cost domestic suppliers. If Japanese firms wish to handicap themselves in this way, what foreign firms lose in intermediate goods markets, they will make up in final goods markets. In any event, experience has shown that when Japanese producers are confronted with vigorous competition, they are quite prepared to shift from domestic to foreign suppliers in the interest of maintaining market shares and profits. For example, when Japan's tobacco market was finally opened to foreign competition in the mid- and late 1980s, the newly privatized Japan Tobacco Corporation discarded decades-old relationships with domestic cigarette paper suppliers and packagers in an effort to remain competitive.

It is often difficult to understand why there is so much emphasis on

35. W. BAUMOL, S. BLACKMAN & E. WOLFF, *PRODUCTIVITY AND AMERICAN LEADERSHIP* 276-77 (1989).

Japanese firms' relationships with their suppliers. Formally speaking, American firms are far more vertically integrated than their Japanese counterparts. For example, eighty percent of the purchased value of a General Motors automobile is provided either by GM or its wholly-owned subsidiaries. By contrast, in Japan, on average only 25% of an automobile's purchase value is made in-house for Japanese manufacturers.³⁶ If there is nothing discriminatory or collusive about the possibly much larger American intra-company transactions, it is difficult to see what is discriminatory or collusive about similar Japanese practices.

As part of the SII talks, and in an effort to deal with anti-competitive practices as might arise from either long-standing vertical or horizontal relationships, the Japanese government has agreed to enhance the Anti-Monopoly Act and to significantly increase the resources devoted to its enforcement. The Fair Trade Commission has had its staff permanently increased by 20%. It is anticipated that with this enlarged staff, the Fair Trade Commission will resort to more transparent, formal proceedings, including criminal actions, when dealing with alleged collusion by Japanese firms. The Japanese government also is in the process of submitting a bill to the Diet which would increase the financial penalties for violations of the Anti-Monopoly Act.³⁷

F. *Distribution System*

While great concern with the procurement practices of Japanese private firms and with the low priority given shareholders' rights by Japan's Ministry of Finance may not be warranted provided there is free entry into Japan's final goods market, the operation of Japan's Large-Scale Retail Store Law does call this premise into question. This law provides that a construction plan for any store of more than 500 square meters must be discussed by a committee of the local Chamber of Commerce and approved by the prefectural governor and/or the Ministry of International Trade and Industry. Since the early 1980s, the administration of this law has been such that it has commonly taken more than two years for a construction plan to receive final approval. Before final approval is granted, some adjustment is often made in the floor space, the number of days the store will be open during a week, the store hours and the total number of days the store will be open during the year.³⁸

36. Aoki, *Horizontal vs. Vertical Information Structure of the Firm*, 76 AM. ECON. REV. 971, 973 (1986).

37. THE SII REPORT, *supra* note 10, at IV-3 (report by Japanese Delegation).

38. T. Ito & M. Maruyama, *Is the Japanese Distribution System Really Inefficient?* 14 (pa-

For all the nuisance value of this law, its actual impact on the character of Japanese distribution is difficult to establish. Contrary to its overseas reputation, the Japanese distribution system does not appear to be inefficient. While there are many small stores in Japan, productivity is high and profit margins are not out of line with the experience of most other countries, including the United States.³⁹ Even in the absence of the Large-Scale Retail Store Law, Japan would have an abundance of small stores because the space in the average Japanese home is extremely limited and because Japanese retailers have very low re-order costs.⁴⁰

Even if the Large-Scale Retail Store Law is effective in changing the size mix of retail establishments, should U.S. trade officials be concerned? To be sure, there is some reason to believe that the size distribution of retail and wholesale establishments can make a difference for the access of foreign products to the Japanese market. Japan's large department stores and supermarket chains import directly from overseas, while smaller retailers and wholesalers must typically rely on one of the giant general trading companies to stock their shelves and inventories. By relying on these general trading companies, which handle a majority of all Japanese imports, small-scale Japanese distributors' opportunities to stock foreign products may be limited. It is argued that Japan's trading companies may restrict what they import, not so much as to protect their own domestic production, of which they do little, but rather to protect the interests of other firms to which they are tied through their *keiretsu* affiliations. It remains an open question, however, whether *keiretsu* ties are sufficiently strong to warrant any conclusion about the impact trading companies might have on the level and structure of Japanese imports.

Under pressure from the SII negotiations, the Japanese government has undertaken both to revise the administration of the Large-Scale Retail Store Law and to consider revising the Law itself. Under the new administrative guidelines being implemented, neither MITI nor local governments will be able to delay beyond a year and one-half the approval of building plans for retail stores. Efforts to further deregulate the distribution industry and to remove the many handi-

per presented at National Bureau of Economic Research Conference on the United States and Japan: Trade and Investment, Oct. 1989).

39. M. Maruyama, Y. Togawa, K. Sakai, N. Sakamoto & M. Arakawa, Distribution System and Business Practices in Japan 5-6 (paper presented at EPA International Symposium, Oct. 12-13, 1989).

40. D. Flath, Why Are There So Many Retail Stores in Japan? 5 (Oct. 1987) (unpublished manuscript).

caps placed on large-scale distributors are also being pursued.⁴¹

CONCLUSION

While heralded as a new departure in international economic relations, in fact the Structural Impediments Initiative discussions are the culmination of decades of bilateral negotiations between the United States and Japan. Because of the asymmetry in U.S.-Japanese trade relations, the U.S. government has repeatedly found it efficacious to deal with Japan largely outside of the formal disciplines of multilateral institutions. American trade officials and businessmen have long believed that harmonizing Japan's domestic economic institutions with those of the United States will lead to more intimate and more balanced economic relations between Japan and the United States.

This article concludes that the traditional theory of comparative advantage does not provide a rationale for SII. However, new developments in international trade theory, particularly those theories which explain the structure and volume of intra-industry trade, do suggest that mutually beneficial increases in trade can result as two dissimilar economies come increasingly to resemble one another.

Unfortunately, in practice a number of the proposals being urged on the Japanese in the context of SII may have consequences directly opposite from those intended by their proponents. The decline in the price of Japanese land sought by American negotiators in SII may increase rather than lower Japan's current account surplus. Japan's importation of America's anti-trust laws may make the Japanese economy less, rather than more, efficient.

Finally, SII may constitute a far deeper intrusion into the Japanese economy than is necessary in order to achieve its stated objective. Discriminatory purchasing practices by private Japanese firms, whatever their cause, for the most part cannot long be sustained if final goods markets in Japan are open to vigorous competition from foreign manufacturers. For this reason, U.S. trade officials are correct in making the reform of Japan's distribution system one of their highest priorities.

41. THE SII REPORT, *supra* note 10, at III-1 (report by Japanese Delegation).

